Internal Revenue Service

memorandum

TL-N-9542-87
Br1:CEButterfield

date: AUG 26 1987

to: District Counsel, Manhattan CC:MAN

from: Director, Tax Litigation Division CC:TL

subject: [redacted]

This is to discuss further the issues raised by our technical advice reply of July 8, 1987.

ISSUE

We have already provided you with advice concerning whether or not the taxpayer should be allowed a present deduction for amounts to be paid over the life of a payee, contingent on the payee's survival. You asked that we provide further information regarding distortion of income, present value considerations and to assist in distinguishing such cases as Buckeye International, Inc., T.C. Memo 1984-668 and Imperial Colliery Co., Inc. v. United States, 599 F. Supp. 653 (S.D.W.V. 1984).

CONCLUSION

As we concluded previously, we do not believe that a present value deduction can be legally required of petitioner, either under I.R.C. § 461 or under a distortion of income analysis. Our conclusion that we have no legal authority to require a deduction to be limited to the present value of the future expenditure does not preclude us, however, from asserting that the span of time in this case between the deduction and the eventual cash outlay creates the type of distortion of income found to warrant the disallowance of a deduction in Mooney Aircraft. We believe the reasoning in that case to be strongly applicable here.

LEGAL ANALYSIS

There are several potential arguments to be made based on both the time value of money and the lapse of time in this case. We have concluded that although reason supports an argument under section 446 that the time value effects would allow us to reduce the $[redacted] deduction to its present value (which may or may not be the $[redacted] originally deducted by petitioners), no authority other than reason supports such an argument. In fact, our research indicates that there are

08340

some contrary authorities in the case law and legislative history. However, we do believe that the time value effects are a valid consideration in making the simple determination that a distortion of income exists. Once such a determination has been made, the distortion may be remedied in the manner authorized by section 446, as applied in Mooney Aircraft; that is, the deduction may be disallowed. Further indications that a deduction would distort income may be found in the effects of the lapse of time, without regard to the effects of time value. That is, even if a present value deduction were taken in year one, the petitioner would not be deprived of the use of the money until years five through sixteen. Even though the time value considerations would have arguably been addressed, the unreasonable span of time between the taking of the deduction and the making of the expenditure results in a distortion of income giving the Commissioner a second basis to find such a distortion, and disallow the deduction.

Given the wide discretion vested in the Commissioner to alter accounting treatment in a manner that more clearly reflects income, it would seem logical, even compelling, that he would have the authority to reduce a face value deduction to present value. Our research has indicated that this is not the case. In fact, there are sufficient contrary indications in the cases and legislative history, that we do not believe the Service could raise such an argument in good faith. The legislative history to the new section 461(h) is most pursuasive on this subject. Congress indicated throughout the discussions of the new economic performance requirement that time value considerations were not built into the timing of deduction provisions of the Code. Rather than construct a more administratively cumbersome requirement of time value discounts, Congress created a requirement of economic performance that would essentially put taxpayers such as petitioner on the cash basis. Congress did so to redress the lack of any time value discount requirement in the pre-existing Code. H.R.Rep. No. 432, Pt. 2, 98th Cong., 2d Sess., 1254 (1984); S. Rep. No. 169, Vol. 1, 98th Cong., 2d Sess., 266 (1984).

Even in the face of a declaration by Congress that there was no time value discount requirement in the pre-1984 Code, we examined the possibility that an argument for requiring a present value deduction could be brought in under section 446, through a distortion of income line of reasoning. As discussed above, we do not believe that such an argument would be well-advised. We could argue that with the prevailing rates of interest and inflation a current deduction of $15,000 to be paid out in 15 years is a gross distortion of income. We would not argue, however, that the Commissioner has the authority to remedy a distortion based on the time value of money by requiring a present value deduction. We would only argue that the existence of a distortion due either to the time value of money or the lapse of time between a face value or a present value deduction and the later expenditure of money for which the deduction was taken may be redressed by the disallowance of the deduction, based on the authority of Mooney Aircraft. We refer you to the case of Denver & Rio Grande Western Railroad Company v. United States, 318 F.2d 922 (Ct. Cl. 1963) which considered the valuation of a non-marketable obligation. At page 928 the court stated

> [t]o go further and require the current assessment of the worth of non-realizable or non-marketable obligations - instead of waiting the actual receipt of money under these obligations - would thrust both taxpayers and the Internal Revenue Service in to the briar patch of valuation-sans-market. The new principle would necessarily have to be expanded, in logic, from fixed but non-realizable liabilities to cover contingent obligations (which can also be "valued") - and the result would soon be a profound shift in the tax treatment of obligations to pay money or transfer property in the future . . . . If the change is to be made, it seems to us it should be made by Congress. . . .

As, indeed, it was. Further discussion of time value concepts before and after 461(h) can be found in John A. Biek, Salvaging Accrual Method Deductions: Adding a "Time Value of Money" Component to the "All Events" Test, 40 Tax Lawyer 185 (Fall 1986), and Daniel I. Halperin, Interest in Disguise: Taxing the "Time Value of Money", 95 Yale L. J. (January 1986). These articles, as well as the dearth of case law discussing a requirement that deductions be discounted to present value, lead us to conclude that it would be inappropriate to advance such an argument under either section 461 or section 446.

Even in United States v. Hughes Properties ___ U.S. ___, 106 S.Ct. 2092 (1986), where the Court ruled against the Service on the first prong analysis of the all-events test, in response to the government's assertion that taxpayers might add numerous high jackpot slot machines to the floor on the last day of the fiscal year, or raise the odds to a level that the jackpots would never be won, thus controlling the amount of liability they wished to deduct, they stated that "the Commissioner's ability, under 446(b) of the Code, 26 U.S.C. § 446(b), to correct any such abuse is the complete practical answer to the Government's concern . . . the Commissioner has the power to find that its accounting does not accurately reflect its income and to require it to use a more appropriate accounting method." Id. at 2099. The Court continued to state that the government had vastly overestimated the time value of the deductions (the time span at issue in Hughes Properties was approximately four years). We cannot overinterpret such an off-hand remark as authority to force a present value deduction where the time value is more extreme, such as in your case. However, we can derive an implication that time lapse is a legitimate area of inquiry under section 446 in a determination by the Commissioner that a distortion of income exists. Should the span of time involved indicate that a distortion of income is present, the Commissioner may reallocate the deduction to reflect income.

Although we have rejected the idea of arguing that a deduction can be limited to the present value of the liability for which the deduction is sought, we continue to believe that a strong argument can be made that the plain lapse of time between accrual and expenditure causes a distortion of income. The Mooney Aircraft case is directly analogous to this one (albeit it dealt with a longer span of time). Taxable income is intended to reflect a taxpayer's current ability to pay tax. In R.C.A. Corp. v. United States, 664 F.2d 881 (2d Cir. 1981), the Second Circuit rejected a method of deferring income because "[t]ax accounting . . . tends to compute taxable income on the basis of the taxpayer's present ability to pay the tax as manifested by his current cash flow." Id. at 888. Mooney and R.C.A. Corp. both bear a logical relationship to the more general principles of matching and annual accounting on which the income tax is based. United States v. Catto et al., 384 U.S. 102 (1966), Beacon Publishing Co. v. Commissioner 218 F.2d 697 (10th Cir. 1955). The Commissioner has great discretion to reallocate return items to years more clearly reflective of income. Thor Power Tool Co. v. Commissioner, 439 U.S. 522 (1979); Schlude v. Commissioner, 372 U.S. 128 (1963). In this case sixteen years will elapse between the deduction and the last payment, four years between the deduction and the first payment we are contesting. Such a span of time creates a greater distortion than the one the Court rejected in Hughes Properties, and much more akin to the one at issue in Mooney Aircraft. As the R.C.A. Corp. case states, tax accounting is intended to be reflective of the current ability to pay tax. While accruals are permitted under the Code, they will not be allowed when the lapse of time is such that they result in a distorted reflection of the taxpayer's current ability to pay tax.

You also informed us that petitioner has raised workman's compensation cases which they assert are analogous to their position. We disagree. Buckeye International was mentioned in particular and we would expect to see Imperial Colliery raised with it. The most compelling distinction between these cases and [redacted] is the statutory creation of liability in the [redacted]mpensation line of cases. The court in Buckeye particularly distinguished Trinity Construction Co. v. United

States, 424 F.2d 302 (5th Cir. 1970) based on the unique facts and the contingent nature of the contractual agreement between the parties. Buckeye at 84-2707, n. 5. In Trinity the issue was the present deductibility of an obligation to pay insurance premiums on behalf of two former employees. The court held that each future payment was contingent on the survival of the former employees. Thus, all the necessary events had not yet occurred to fix the liability. Awards in the workers compensation cases were made by state commissions; they were fixed in amount and timing, and the individuals responsible for paying them had no latitude in any of these matters to make the payment structure more convenient, to consider tax effects, or to insert contingencies such as survival into payment structures. There was no potential for manipulation by the taxpayer. We note also that Imperial Colliery and Buckeye both excluded contested claims. The only contingency that could be asserted to prevent liability from accruing would be a contest of the claim by the employer. There may be moreover, a greater reflection of income in accruing annually the year's uncontested workmen's compensation claims in an ongoing business, where, presumably, claims tend to be made evenly over the course of the years. The distinction we would emphasize is that companies do not structure the workmen's compensation claims made against them. They are framed by statute and by state administrative agencies. Cash reserves are often part of the required scheme. In this case petitioner's themselves created the settlement, and bargained to hinge part of the liability on survival. In the worker's compensation cases the death of a payee before the end of his actuarial life expectancy is an event subsequent that lessens the amount of obligation. It does not effect liability. The injury, the filing of a claim, and the determination not to contest the claim are the events that trigger and fix liability under the statutory compensation structure. In a tort litigation the defendant may prevail, thus there may be no liability. Any settlement establishing such liability must be examined on its own terms. The terms of this settlement created liability for four years of payments and created the possibility of liability in the future based on the payee's survival. In contrast to the present situation see Rath Packing Company v. Bacon, 255 F. Supp. 809 (S.D. Iowa 1966) in which accrual was allowed because taxpayer had contractually committed itself to make regular payments into a fund and did so, regardless of the facts that the fund was intermingled with taxpayer's other accounts, and that no disbursements were actually made. In this case petitioner has not purchased an annuity, created an irrevocable reserve or otherwise made provision against this purported liability. Thus Rath Packing is readily distinguishable.

An alternative argument is presented by the case of ESCO Corporation v. United States, 578 F. Supp. 738 (D. Oregon 1983), rev'd, 750 F.2d 1466 (9th Cir. 1985). In ESCO the taxpayer sought to accrue workmen's compensation reserves. The court affirmed the Commissioner'sdisallowance of the deduction under section 446, but under a change in method argument. The government asserted that the accrual of these reserves represented a change in method with respect to a material item for which consent had not been sought or obtained. If you have facts available to you regarding past accounting practices with regard to tort liabilities and they demonstate a change in method, you may be able to develop an argument using the reasoning in ESCO.1/

In sum, petitioner has not satisfied the first prong requirement of the all-events test with respect to its liability beyond the first four years of the structured settlement. The workmen's compensation cases petitioner's counsel mentioned as supporting their position are distinguishable because they arise in the context of a detailed state statutory scheme that creates liability for specific events and in specific amounts. Moreover, to allow a deduction at this time, particularly in the amended amount of $[redacted], would create a distortion of income such as the one found in Mooney Aircraft, because the taxpayer will obtain the benefit of the deduction in the tax year at issue, while retaining the use of the money over a long span of time.

If you have any questions in regard to this matter please call Ms. Clare E. Butterfield at FTS/566-3521.

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1/ As indicated, the ESCO case was reversed on appeal. Although the change in method argument was rejected by the Ninth Circuit, the grounds for their doing so were largely dependent on the particular facts of the case, and tied to an evidentiary determination. We would therefore not foreclose the ESCO argument in cases with distinguishable facts in other Circuits.